
State Controller's Financial Overview

ECONOMIC OUTLOOK

During 1998, California's economic growth outpaced that of the nation, a performance that will most likely be repeated in the coming year. Even with a slowdown in job growth, it is expected that employment in 1999 will increase by 2.4% in California, twice the rate of increase for the nation as a whole.

The strong economy, along with a robust stock market, helped to generate higher revenues to the State. In fiscal year 1997-98, revenues from personal income tax receipts, the largest single source of revenue to the General Fund, grew by 20%. Overall tax receipts grew by 11%. This trend in tax revenues is also the result of baby boomers passing through their prime earning years. Within the next decade, however, this generation will begin to retire, slowing the rise in personal income tax revenues.

Despite major disruptions in international markets during 1998, California's economy has weathered the Asian financial storm with relatively modest damage. Increased exports to NAFTA trading partners and Europe compensated for declines in California's exports to Southeast Asian countries over the past year.

The construction industry led California's employment growth in 1998. From October 1997 to October 1998, construction jobs in the state increased by more than 9%. By the end of 1998, residential permits are expected to reach 125,000 units, an increase of more than 11%. In the previous year, permits totaled 111,000 units, topping 100,000 for the first time since 1991.

Rising incomes and confidence in the economy have propelled housing sales and prices to record levels in many parts of California. The San Francisco-San Jose metropolitan area has seen the greatest price appreciation and is now the most expensive housing market in the nation. Statewide, sales of existing single family homes in 1998 are expected to show a 10% increase over 1997 levels. By the end of the year, the median price should surpass the peak in 1991.

The healthy economic climate and recent revisions to the State's welfare system have produced a major turnaround in the growth of California's welfare population. This trend began in 1996, when there was a slight decline in California's public assistance caseloads, the first since 1980. In 1997, there was a drop of almost 5%. As of August 1998, caseloads were down by nearly 10% over the previous 12 months.

California's future rests on its investments in the State's education system. The State's economy is increasingly driven by technology-oriented industries, and a supply of skilled workers is indispensable to the health of the economy. Recent increases in funding for California's public education system represent progress in meeting this need.

MAJOR INITIATIVES FOR THE YEAR

The 1997–98 fiscal year continued the trend of the past three years in which tax revenues to the General Fund exceeded levels that were anticipated when the budgets were enacted. These additional revenues totaled roughly \$2.2 billion in 1997–98.

Given the higher revenues, the 1997–98 Budget Act contained a large increase in funding (\$1.75 billion) for K–14 education under Proposition 98. Part of the increased spending was allocated to prior fiscal years. Funds were provided to fully pay the cost-of-living increase component of Proposition 98 and to extend the class size reduction and reading initiatives.

Other significant elements of the 1997–98 Budget Act included the following:

- Payment of \$1.2 billion was made to satisfy the judgment in a lawsuit involving payments to the State's pension fund, and funding of the State's pension contribution was returned to the quarterly basis that existed prior to the deferral actions that were invalidated by the courts.
- General Fund support for the University of California and California State University was increased by approximately 6% (\$121 million and \$107 million, respectively). Student fees were not increased.
- Most other state programs were maintained at fiscal year 1996–97 levels, adjusted for caseload changes.
- State health and welfare costs were contained, continuing generally the grant levels from prior years, as part of the initial implementation of the new CalWORKs program.
- Approximately \$300 million in federal funds, already included in the federal fiscal year 1997 and 1998 budgets, was included in the Budget Act to offset incarceration costs for illegal aliens.
- The Budget Act contained no new tax increases, nor tax reductions. The Renters Tax Credit was suspended for another year, at a savings of approximately \$500 million.

**FINANCIAL
INFORMATION**

Reporting Entity: The financial reporting entity of the State includes all the funds and account groups of the primary government as well as all of its component units. Component units are legally separate entities for which the primary government is financially accountable. Blended component units, although legally separate entities, are, in substance, part of the primary government's operations and are included as part of the primary government. Accordingly, the building authorities are reported within the capital projects funds of the primary government. The lease agreements, amounting to \$319 million between the building authorities and the primary government, have been eliminated from the combined balance sheet. Instead, only the underlying fixed assets and the debt used to acquire them are reported in the appropriate account groups. Discretely presented component units are reported in separate columns in the combining financial statements to emphasize that they are legally separate from the primary government and to differentiate their financial position, results of operations, and cash flows from those of the primary government. The University of California and special purpose authorities are reported as discretely presented component units.

Budgetary Controls: Annually, the State Legislature prepares a budget that contains estimates of revenues and expenditures for the ensuing fiscal year. This budget is the result of negotiations between the Governor and State Legislature. Throughout the fiscal year, adjustments in the form of budget revisions, executive orders, and financial legislation agreed to by the parties are made to the budget. The Controller is statutorily responsible for maintaining control over revenues due the primary government and the expenditure of each appropriation contained in the budget. Budgeted appropriations are the expenditure authorizations that allow state agencies to purchase or create liabilities for goods and services.

The accounting system provides the Controller's Office with a centralized control record system to fully account for each budgeted appropriation, including its unexpended balance, and for all cash receipts and disbursements. The accounting system is decentralized in that the detail of each control account is maintained at the agency level. During the fiscal year, the control accounts and agency accounts are maintained and reconciled on a cash basis. At the end of the fiscal year, each agency prepares annual accrual reports for receivables and payables. The Controller's Office combines its control accounts with the agency accrual reports to prepare the *Budgetary/Legal Basis Annual Report* and *Budgetary/Legal Basis Annual Report Supplement*. The methods of accounting for expenditures and revenues in this report are governed by state laws and regulations that, in some cases, are not in full agreement with generally accepted accounting principles. The information in the

Comprehensive Annual Financial Report presents a consolidation of the amounts in the *Budgetary/Legal Basis Annual Report* and adjustments to the account balances to conform to generally accepted accounting principles.

Internal Controls: An internal control structure has been designed to ensure that the assets of the government are protected from loss, theft, or misuse, and to ensure that adequate accounting data are compiled to allow for the preparation of financial statements in conformity with generally accepted accounting principles. The internal control structure is designed to provide reasonable, but not absolute, assurance that these objectives are met. The concept of reasonable assurance recognizes that: (1) the cost of a control should not exceed the benefits likely to be derived, and (2) the valuation of costs and benefits requires estimates and judgments by management. In addition, the government maintains extensive budgetary controls. The objective of these controls is to ensure compliance with legal provisions embodied in the annual appropriated budget approved by the Legislature.

General Government Functions: The government provides a full range of services including education, health and social services, transportation, law, justice, public safety, recreation, resource development, and public improvements. These general government functions are accounted for in the General Fund, special revenue funds, and capital projects funds.

Chart 1

REVENUES 1997-98
General, Special Revenue, and
Capital Projects Funds

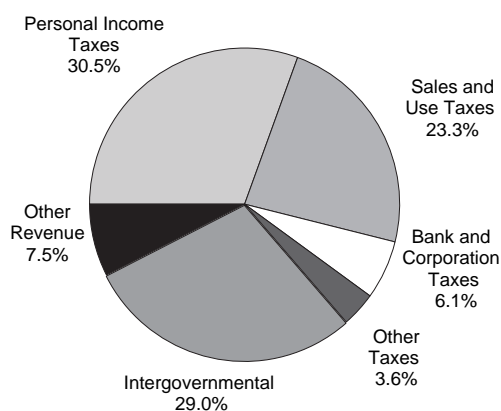
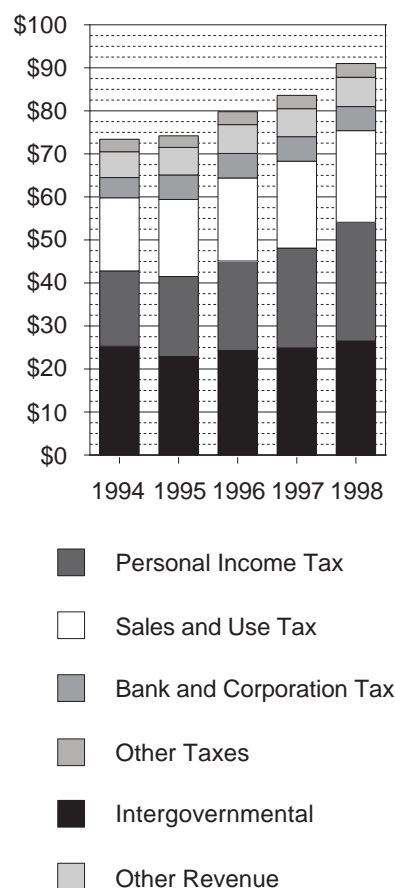


Chart 2

REVENUES by SOURCE
General, Special Revenue, and
Capital Projects Funds
 (Amounts in billions)



1997-98 Revenues: Table 1 presents a summary of General Fund, special revenue funds, and capital projects funds revenues for the year ended June 30, 1998. Revenues for the General Fund, special revenue funds, and capital projects funds totaled \$91.3 billion for the year ended June 30, 1998. This was an increase of \$6.4 billion, or 7.5%, over the previous year. Tax revenues increased \$5.9 billion, or 11.3%, over the previous year. Personal income, sales and use, and other taxes increased \$4.7 billion, \$1.1 billion, and \$125 million, or 20.2%, 5.6%, and 4.0%, respectively. Bank and corporation taxes decreased \$73 million, or 1.3%. Intergovernmental revenue increased \$106 million, or 0.4%.

Five-Year Trend: Total revenues for the General Fund, special revenue funds, and capital projects funds have increased from \$73.5 billion in 1994 to \$91.3 billion in 1998, an increase of \$17.8 billion, or 24.3%. This trend of increasing revenue is the result of a rebounding California economy that is generating increased collections of taxes. Personal income taxes have increased from \$17.5 billion in 1994 to \$27.9 billion in 1998, an increase of \$10.3 billion, or 59.0%. Sales and use taxes have increased from \$17.0 billion in 1994 to \$21.3 billion in 1998, an increase of \$4.3 billion, or 25.0%. Total revenues for the five-year period increased \$2.4 billion, \$770 million, \$5.7 billion, \$5.0 billion, and \$6.4 billion in the years ending June 30, 1994, 1995, 1996, 1997, and 1998, respectively.

Table 1

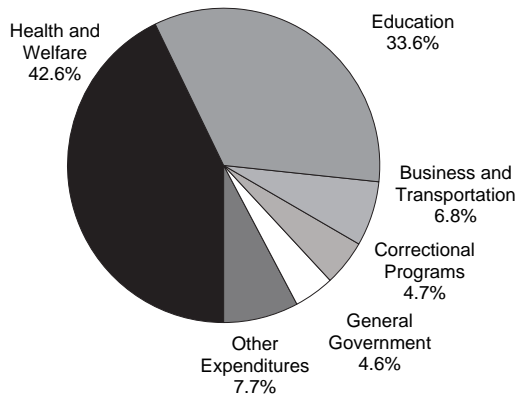
Schedule of General Fund, Special Revenue Funds, and Capital Projects Funds Revenues

Year Ended June 30, 1998 (Amounts in thousands)

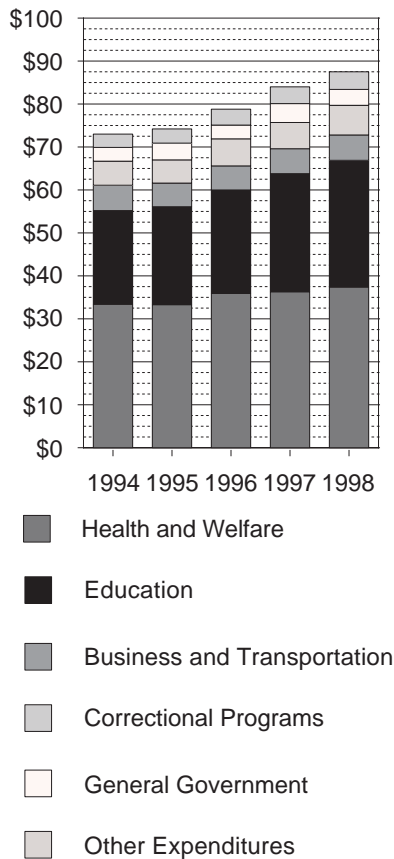
Sources	1997-98 Amount	Percent of Total	Increase (Decrease) from 1996-97	Percent of Increase (Decrease)
Taxes				
Personal income.....	\$ 27,858,619	30.5 %	\$ 4,681,908	20.2 %
Sales and use.....	21,304,784	23.3	1,138,113	5.6
Bank and corporation.....	5,601,526	6.1	(72,523)	(1.3)
Other taxes.....	3,254,641	3.6	124,761	4.0
Intergovernmental.....	26,503,684	29.0	106,313	0.4
Other revenue				
Licenses and permits.....	3,188,395	3.5	171,188	5.7
Fees and penalties.....	1,972,623	2.2	(56,137)	(2.8)
Charges for services.....	607,153	0.7	197,365	48.2
Interest.....	600,612	0.7	95,678	18.9
Other minor.....	370,195	0.4	23,694	6.8
Natural resources.....	39,704	0.0	(53,627)	(57.5)
Total.....	\$ 91,301,936	100.0 %	\$ 6,356,733	7.5

Chart 3

EXPENDITURES 1997-98
General, Special Revenue, and
Capital Projects Funds

**Chart 4**

EXPENDITURES by FUNCTION
General, Special Revenue, and
Capital Projects Funds
 (Amounts in billions)



1997-98 Expenditures: Table 2 presents a summary of General Fund, special revenue funds, and capital projects funds expenditures for the year ended June 30, 1998. Expenditures for the General Fund, special revenue funds, and capital projects funds totaled \$87.7 billion for the year ended June 30, 1998. This was an increase of 2.0%, or \$1.7 billion, over the previous year. Changes in expenditures by function from the previous year's levels are presented in Table 2. Education expenditures increased by \$1.8 billion, or 6.7%, which was related to decreases in class size in Kindergarten through 3rd grade and increases in the average daily attendance. Health and Welfare expenditures decreased \$822 million, or 2.2%, which relates to reduced claims resulting from California's improved economy.

Five-Year Trend: Total expenditures for the General Fund, special revenue funds, and capital projects funds have increased from \$72.8 billion in 1994 to \$87.7 billion in 1998, an increase of \$14.9 billion, or 20.4%. During this period, expenditures have increased 11.9% for health and welfare, 35.6% for education, and 31.7% for corrections. In aggregate, expenditures for the five-year period increased \$3.0 billion, \$1.4 billion, \$4.6 billion, \$7.2 billion, and \$1.7 billion in the years ending June 30, 1994, 1995, 1996, 1997, and 1998, respectively.

Table 2

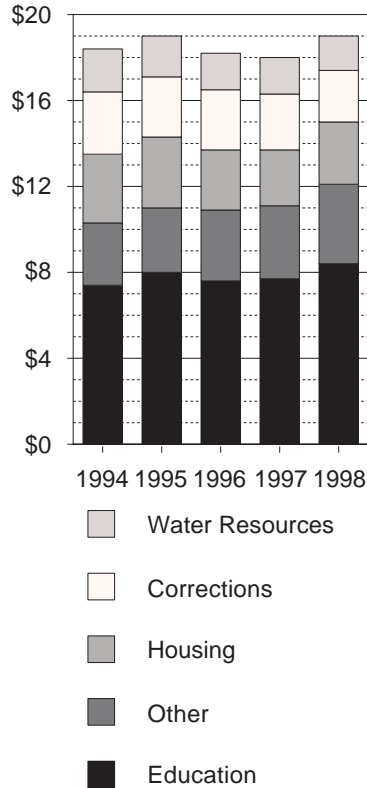
Schedule of General Fund, Special Revenue Funds, and Capital Projects Funds Expenditures

Year Ended June 30, 1998 (Amounts in thousands)

Function	1997-98 Amount	Percent of Total	Increase (Decrease) from 1996-97	Percent of Increase (Decrease)
Health and welfare.....	\$ 37,333,877	42.6 %	\$ (822,292)	(2.2) %
Education.....	29,501,259	33.6	1,840,179	6.7
Business and transportation.....	5,953,332	6.8	143,699	2.5
Correctional programs.....	4,092,202	4.7	241,247	6.3
General government.....	4,026,111	4.6	(413,475)	(9.3)
Other expenditures				
Debt service.....	2,103,476	2.4	(47,566)	(2.2)
Resources.....	1,975,661	2.2	64,005	3.3
State and consumer services.....	747,211	0.9	17,228	2.4
Property tax relief.....	617,320	0.7	(13,637)	(2.2)
Capital outlay.....	1,360,788	1.5	691,666	103.4
Total.....	\$ 87,711,237	100.0 %	\$ 1,701,054	2.0

Chart 5

**GENERAL
OBLIGATION BONDS
by FUNCTION**
(Amounts in billions)



Debt Administration: On July 30, 1996, Standard and Poor's Rating Group raised its bond rating for California from "A" to "A+," and in October 1997, Fitch Investors Services raised its rating from "A+" to "AA+." Moody's Investors Service rating is "A1."

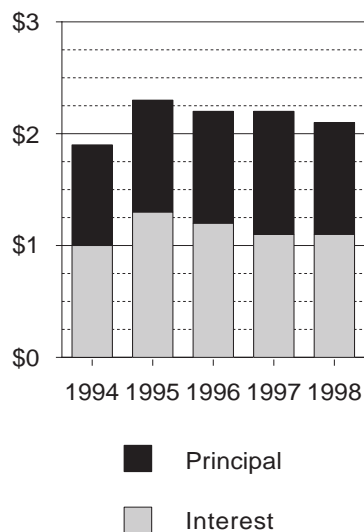
General Obligation Bonds: General obligation bonded debt, which is backed by the full faith and credit of the General Fund, increased from \$18.0 billion on June 30, 1997, to \$18.9 billion on June 30, 1998. This change reflected an increase of \$957 million, or 5.3%.

Five-Year Trend: Total outstanding general obligation bonds have increased from \$18.4 billion in 1994 to \$18.9 billion in 1998. This is an increase of \$512 million, or 2.8%. During this period, education and other general purpose bonded debt has increased from \$10.3 billion in 1994 to \$12.0 billion in 1998, an increase of \$1.8 billion, or 17.0%. Also during this period, bonded debt for water resources, corrections, and housing has decreased from \$8.1 billion in 1994 to \$6.9 billion in 1998, a decrease of \$1.2 billion, or 15.3%. In aggregate, general obligation bonds for the five-year period increased (decreased) \$758 million, \$679 million, \$(871) million, \$(252) million, and \$957 million in the years ending June 30, 1994, 1995, 1996, 1997, and 1998, respectively.

Debt Service: Principal retirement expenditures for the General Fund, special revenue funds, and capital projects funds totaled \$1.0 billion for the year ended June 30, 1998. This change reflected a decrease of \$57 million, or 5.4%, over the previous year. Interest and fiscal charges for these funds totaled \$1.1 billion for the year ended June 30, 1998. This was an increase of \$9 million, or 0.9%.

Chart 6

**DEBT SERVICE
EXPENDITURES**
(Amounts in billions)

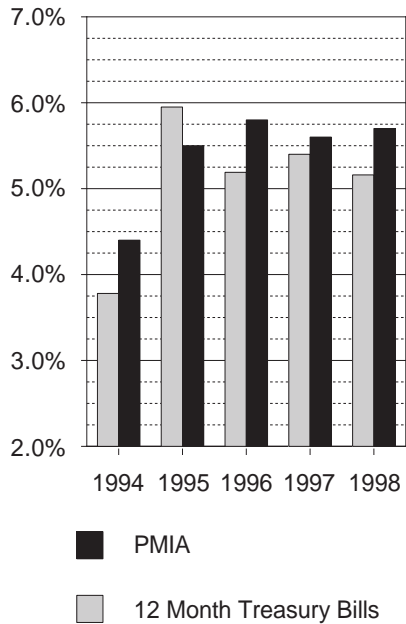


Five-Year Trend: General Fund, special revenue funds, and capital projects funds principal retirement expenditures increased from \$874 million in 1994 to approximately \$1.0 billion in 1998, an increase of \$128 million, or 14.6%. Interest and fiscal charges increased from \$1.0 billion in 1994 to approximately \$1.1 billion in 1998, an increase of \$91 million, or 9.1%.

Cash Management Policies and Practices: Cash temporarily idle during the year was invested in the Pooled Money Investment Account (PMIA). The investment of the PMIA is restricted by law to the following categories: U.S. Government securities, securities of federally sponsored agencies, domestic corporate bonds, bank notes, interest-bearing time deposits in California banks and savings and loan associations, prime commercial paper, repurchase and reverse repurchase agreements, security loans, bankers' acceptances, negotiable certificates of deposit, and loans to various bond funds. The average daily investment balance for the year ended

Chart 7

**PMIA YIELD and AVERAGE
TREASURY YIELD
Year Ended June 30**



June 30, 1998, amounted to \$29.3 billion, with an average effective yield of 5.7%. For the year ended June 30, 1997, the average daily investment was \$28.3 billion and the average effective yield was 5.6%.

Five-Year Trend: PMIA yield increased from 4.4% in 1994 to 5.7% in 1998. During this same time, the 12-month average yield on Treasury Bills increased from 3.8% to 5.2%. The average daily investment portfolio has also increased from \$25.4 billion in 1994 to \$29.3 billion in 1998, an increase of \$3.9 billion, or 15.4%.

The total earnings of the PMIA for the year ended June 30, 1998, amounted to \$1.7 billion. Of this amount, \$280 million was distributed to the General Fund, \$759 million to special funds, \$629 million to local governments, \$2 million to the Public Employees' Retirement System, and \$2 million to the State Teachers' Retirement System. The Pooled Money Investment Account Portfolio is shown in Table 3.

General Fund Balance: The General Fund ended the year with a budgetary fund balance of \$2.8 billion and a fund balance of \$547 million, using generally accepted accounting principles. The budgetary fund balance includes \$1.9 billion in reserves. The reserves represent that portion of the fund balance that is not available for appropriation or that is legally set aside for specific uses.

Table 3

Pooled Money Investment Account Portfolio

Year Ended June 30, 1998 (Amounts in thousands)

Type of Security	Average Daily Portfolio	Percent of Portfolio	Annual Earnings	Average Effective Yield
Money market.....	\$ 14,782,614	50.3 %	\$ 847,074	5.7 %
Government securities.....	10,023,286	34.2	565,381	5.6
Corporate bonds.....	1,760,775	6.0	104,635	5.9
Loans to other funds.....	2,039,814	7.0	115,458	5.7
Repurchase agreements.....	37,799	0.1	2,125	5.6
Time deposits.....	1,076,268	3.7	57,452	5.3
Reverse repurchase agreements.....	(376,043)	(1.3)	(19,743)	5.3
Total Portfolio.....	\$ 29,344,513	100.0 %	\$ 1,672,382	5.7

The Special Fund for Economic Uncertainties (the “rainy day fund”) had a balance of \$931 million at the end of the year. Annually, an amount is appropriated in the General Fund to replenish the fund. This fund, as the name implies, provides the monies for those necessary expenditures throughout the year that have not been anticipated or provided for in the annual budget. It also provides relief, to the amount of its available funds, for any budgeted revenue shortfalls.

Proprietary Operations: Proprietary fund types present financial data on activities that are similar to those found in the private sector. Users are charged for the goods or services provided.

Enterprise funds account for goods or services provided to the general public on a continuing basis when the cost involved is to be financed or recovered primarily by user charges. Enterprise funds earned approximately \$4.2 billion in operating revenues and had \$3.1 billion in operating expenses for the year ended June 30, 1998.

Internal service funds account for activities that provide goods and services to other state departments or agencies on a cost reimbursement basis. Internal service funds earned approximately \$2.2 billion in operating revenues and had \$2.2 billion in operating expenses for the year ended June 30, 1998.

Fiduciary Operations: Fiduciary fund types are used to account for assets held by the primary government as a trustee or agent. Four fiduciary fund types are reported: expendable trust funds, which account for assets held in a trustee capacity when both principal and income (earnings on principal) may be expended in the course of a fund’s designated operations; pension trust funds, which account for transactions, assets, liabilities, and net assets available for plan benefits of the retirement systems; agency funds, which account for assets held by the primary government and where the primary government acts as an agent for individuals, private organizations, other governments, or other funds; and the investment trust fund, which accounts for deposits, withdrawals, and earnings of the Local Agency Investment Fund, an external investment pool for local governments and public agencies. Expendable trust funds earned approximately \$6.5 billion in revenues and had \$6.2 billion in expenditures for the fiscal year ended June 30, 1998. Pension funds had \$44.0 billion in additions and \$8.0 billion in deductions to the net assets available for plan benefits. The investment trust fund had net assets of \$11.7 billion as of June 30, 1998. Agency funds had assets and liabilities of \$19.5 billion as of June 30, 1998.

Risk Management: The primary government has elected, with a few exceptions, to be self-insured against loss or liability and generally does not maintain reserves. Losses are covered by appropriations in the year in which the payment occurs. Workers' compensation benefits for self-insured agencies are initially paid by the State Compensation Insurance Fund. The liability for future workers' compensation claims against the self-insured agencies is estimated to be approximately \$886 million as of June 30, 1998. Of this amount, \$118 million is being reported in the General Fund, \$73 million in special revenue funds, \$18 million in proprietary funds, and \$677 million in the General Long-Term Obligations Account Group.

Independent Audit: State statutes require an annual audit of the general purpose financial statements of the State. To meet this requirement, the State Auditor has examined the accompanying financial statements in accordance with government auditing standards issued by the Comptroller General of the United States and generally accepted auditing standards. The auditor's report on the general purpose financial statements and combining and individual fund statements and schedules is included in this report.

The State of California is required to undergo an annual single audit in conformity with the provisions of the Single Audit Act of 1984, the Single Audit Act Amendments of 1997, and the U.S. Office of Management and Budget's Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations. Generally accepted auditing standards and the standards set forth in the General Accounting Office's Governmental Auditing Standards were used by the auditors in conducting the engagement. Information related to this single audit, including a schedule of federal financial assistance, the independent auditor's report on internal controls and compliance with applicable laws and regulations, and a schedule of findings and questioned costs are included in a separately issued single audit report.

Certificate of Achievement: The Government Finance Officers Association of the United States and Canada (GFOA) awarded the Certificate of Achievement for Excellence in Financial Reporting to the State of California for its *Comprehensive Annual Financial Report* for the year ended June 30, 1997. This is the second consecutive year the State has received this award. To earn this award, a governmental unit must publish an easily readable and efficiently organized comprehensive annual financial report whose contents conform to program standards. The report must satisfy generally accepted accounting principles and applicable legal requirements.

The Certificate of Achievement is valid for only one year. It is the view of the State Controller's Office that this year's report continues to conform to the Certificate of Achievement Program requirements, and it is being submitted to GFOA for its review. The State Controller's Office is committed to ensuring that the *Comprehensive Annual Financial Report* will continue to conform to the Certificate of Achievement Program requirements in the future. The cooperation of state agency accounting departments, the audit by the Bureau of State Audits, and the dedication of the staff of the State Controller's Division of Accounting and Reporting is very much appreciated, without which this award could not have been achieved.

Certificate of Achievement for Excellence in Financial Reporting

Presented to

State of
California

For its Comprehensive Annual
Financial Report
for the Fiscal Year Ended
June 30, 1997

A Certificate of Achievement for Excellence in Financial Reporting is presented by the Government Finance Officers Association of the United States and Canada to government units and public employee retirement systems whose comprehensive annual financial reports (CAFRs) achieve the highest standards in government accounting and financial reporting.



Douglas R. Ellsworth
President

Jeffrey L. Esler
Executive Director

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Pete Wilson
Governor

Gray Davis
Lieutenant Governor

Kathleen Connell
State Controller

Dan Lungren
Attorney General

Matt Fong
State Treasurer

Bill Jones
Secretary of State

Delaine Eastin
Superintendent of Public Instruction

Chuck Quackenbush
Insurance Commissioner

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Johan Klehs, Member, First District
Dean F. Andal, Member, Second District
Ernest J. Dronenburg Jr., Member, Third District
John Chiang, Acting Member, Fourth District

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Antonio Villaraigosa
Speaker of the Assembly

Judicial Branch

Ronald M. George
Chief Justice, State Supreme Court

Organization Chart of the State of California

